

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:MIC:DET:TL-N-6241-99

MELueck

date: **MAY 16 2000**

to: District Director, Michigan District  
Chief, Examination Division  
Attention: [REDACTED], International Examiner

from: District Counsel, Michigan District, Detroit

subject: [REDACTED], Section 1442 Withholding

This memorandum modifies and supplements our Memorandum dated April 24, 2000, wherein we advised you the taxpayer was not required to withhold tax on a distribution under I.R.C. § 1442.

**DISCLOSURE STATEMENT**

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Appeals or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgement of the office with jurisdiction over the case.

### FACTS

[REDACTED] is a domestic corporate manufacturer. Prior to [REDACTED] [REDACTED] and [REDACTED] owned all outstanding shares of [REDACTED]. [REDACTED] and [REDACTED] are unrelated individuals each owning [REDACTED] percent of the issued shares.

On [REDACTED], the shareholders of [REDACTED] elected subchapter S status for the corporation. As a result, the S corporation filed Forms 1120S for the periods [REDACTED] through [REDACTED], and [REDACTED] through [REDACTED]. On [REDACTED], [REDACTED] expatriated, thereby becoming a nonresident alien for U.S. tax purposes. Sometime thereafter, he transferred his shares of [REDACTED] to [REDACTED], a [REDACTED] corporation. Upon [REDACTED]'s expatriation, [REDACTED]'s status as an S corporation was terminated and it entered into its post-termination transition period.

On [REDACTED], [REDACTED] distributed \$[REDACTED] to its shareholders of record. [REDACTED] treated the \$[REDACTED] distribution as a distribution out of its accumulated adjustments account under I.R.C. § 1371(e). Because it determined that none of the distribution was income to the recipient, [REDACTED] did not withhold tax on the distribution to [REDACTED].

### ISSUE

Was [REDACTED] required to withhold tax under I.R.C. § 1442 when it made the post termination distribution to its shareholders?

### CONCLUSION

Because the distribution was made during the corporation's post termination transition period and out of its accumulated adjustment account, no portion of the distribution is treated as a dividend. Accordingly, no portion of the distribution is fixed or determinable annual or periodical income within the meaning of I.R.C. § 881 or § 1441 and, therefore, no withholding is required.

### LAW AND ANALYSIS

The taxation of income earned by an S corporation generally parallels the taxation of a partnership. I.R.C. § 1366. To that end, the subchapter C corporate transaction rules do not apply where the result is inconsistent with the treatment of an S corporation as a pass-through entity. I.R.C. § 1363(a).

Like a partnership, each shareholder in an S corporation separately accounts for his/her pro-rata share of corporate items of income, deduction, loss, and credit on an annual basis. I.R.C. § 1366(a). In turn, the shareholder's basis in the S corporation stock is increased by his/her portion of the items of income separately stated and passed through. I.R.C. § 1367(a)(2). Distributions from an S corporation that has never been a C corporation (i.e., an S corporation with no E&P), are treated first as a nontaxable return of capital to the extent of the shareholder's stock basis and the corporation's accumulated adjustment account, and then as a gain from the sale or exchange of property. I.R.C. § 1368(b); § 1368(e). For this purpose, the corporation's accumulated adjustments account is an account that is adjusted to reflect the net income recognized at the shareholder level during the effective period of the corporation's subchapter S election. § 1368(e).

Distributions made by a former S corporation during its post-termination transition period are treated as if they were made by an S corporation. Conversely, distributions made after the post-termination transition period are generally treated as C corporation distributions (i.e., taxable dividends or return of capital). An S Corporation that has undistributed income at the time of the termination of its election may distribute the income to its shareholders without the distribution being considered a dividend if: 1) the corporation makes the distribution during the post termination period; and 2) the distribution is applied against and reduces the shareholders' basis in their stock (to the extent the distribution does not exceed the corporation's accumulated adjustment account). I.R.C. §§ 1371(e)(1) and 1377(b)(1).

Section 881(a) of the Internal Revenue Code imposes a tax of 30 percent on the amounts received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. Section 1441(a) of the Internal Revenue Code provides, in part, that all persons having control, receipt, custody, disposal, or payment of any items specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual or foreign partnership shall deduct and withhold a tax equal to 30 percent. Section 1441(b) of the Internal Revenue Code enumerates the same types of income listed in section 881(a).

Section 1442 of the Code provides that, in the case of a foreign corporation subject to tax under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items provided in section 1441 a tax equal to 30 percent thereof. Section § 1.1442-1 through -3 of the Income Tax Regulations provides that guidance with respect to I.R.C. § 1442 may be found in § 1.1441-1 through -6. Section 1.1441-3(b) of the Regulations provides, in part, that the tax shall be withheld at the source under § 1.1441-1 on the gross amount of any distribution made by a corporation other than (i) a nontaxable distribution payable in stock or stock rights, and (ii) a distribution which is treated as a distribution in part or full payment in exchange for stock.

In the present case, [REDACTED] made the distribution to [REDACTED] during the post termination transition period and out of its accumulated adjustments account. Accordingly, the distribution is treated as a tax-free distribution from an S corporation to its shareholder. The 1441 withholding regulations do not address distributions from S corporations. This is because, by definition, only U.S. citizens or residents can be S corporation shareholders. Recall, however, that the subchapter C corporate transaction rules do not apply where the result is inconsistent with the treatment of an S corporation as a pass-through entity, (i.e., one level of taxation). Therefore, the previously taxed distribution from [REDACTED] to [REDACTED] should not be treated as a distribution from a C corporation.

Pursuant to section 1441 of the Code, withholding is required on payments of fixed or determinable annual or periodical gains, profits, and income. Given the facts, the post-termination distribution was not a gain, profit or income to [REDACTED]. This is because § 1371(e) requires the distribution to be treated as a return of basis. Therefore, the distribution was not fixed or determinable annual or periodical income within the meaning of § 881 or § 1441.

These facts are distinguishable from Revenue Ruling 72-87. There, a C corporation made a distribution with respect to its stock to a nonresident alien shareholder. At the time of the distribution, the corporation did not know whether a portion of the distribution may be treated as a gain from the sale of property under section 301(c)(3)(A). The ruling concluded that in such circumstances withholding is required on the entire distribution because a corporation cannot determine, conclusively, at the time of payment what portion of the distribution is attributable to earnings and profits and what portion is a return of basis or capital gain. In the present case, no portion of the distribution could be attributable to the corporation's earnings and profits (i.e., a dividend). This is because the entire distribution was made during the post termination transition period and out of the corporation's accumulated adjustments account. Thus, unlike Revenue Ruling 72-87, I.R.C. § 1371(e)(1) conclusively provides that no portion of the distribution is a dividend.

If you have any questions or comments regarding this memorandum or the subject matter addressed, please do not hesitate to contact Michael E. Lueck at (313) 226-4797.

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